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Institutions and Development

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1. Introduction

Gunnar Myrdal's *Asian Drama* (1968) was arguably the first systematic analysis of the role of institutions in Asia's development. Myrdal described his magisterial work as an 'institutional approach' that aimed to explain why conventional economic analysis was providing inappropriate policy advice. Economic policies that worked in advanced countries were failing in Asia, Myrdal argued, because of Asian behavioural norms.[1] Conventional economics assumed that people would respond flexibly and rationally to market incentives, but social, institutional, and political factors made Asians respond in different ways.

Like Myrdal, later institutional economists such as North (1990) or Acemoglu and Robinson (2012) began to explain the poor performance of some developing countries by comparing their market-supporting institutions and informal norms with advanced countries. But like Myrdal, they ignored the Asian countries that performed remarkably well with unorthodox institutions, and they did not ask why similar unorthodox institutions failed to work in other Asian countries. The new institutional analysis failed to explain these variations because, first, it focused only on an analysis of *institutions*, both formal and informal, ignoring how characteristics of organizations and the distribution of *power* between them affected the operation of institutions and the persistence or otherwise of particular behavioural patterns. Second, they also downplayed the critical role of institutions in responding to market failures. Later developmental state theorists did focus on institutions that addressed market failures, in particular, industrial policy institutions. But they, too, ignored the role of power in explaining the effectiveness of *these* institutions. The 'political settlements framework' looks at the interdependence of institutions and organizations, and how the distribution of power across organizations affects the effectiveness of institutions and the persistence of particular types of informal behaviour. This framework can explain the diversity of Asian experiences better and can help to formulate more effective policy.

[1] Myrdal's work takes in India, Pakistan, Ceylon, Burma, Malaya, Thailand, Indonesia, and the Philippines, with occasional references to South Viet Nam, Cambodia, and Laos. However, his in-depth analysis is largely based on India and to a lesser extent Pakistan, with references to other countries supporting the main lines of argument.

One of Myrdal's most influential observations was that states in South Asia were 'soft' and could not enforce social discipline. Political leaders tolerated social indiscipline and inefficiency on the grounds that this was part of 'democratic planning' while engaging in corruption themselves. Myrdal argued that this regressive collective behaviour was the product of attitudes, cultures, and institutions. He was describing something important, but it was an incomplete observation. The soft states were only 'soft' in some areas. They were very hard in others, for instance in repressing communists or secessionists. The weak implementation of *some* institutions and policies is more likely to have been due to the interests of powerful organizations in specific countries and sectors rather than a general feature of their cultures and attitudes. The 'political settlement' describes the distribution of power across different types of organizations. The distribution of organizational power can vary greatly across countries and sectors, and over time, and can help to explain significant differences in institutional outcomes and behavioural patterns.

The relationship between institutions and political settlements can be explored through the lens of industrial policy institutions, which played an important role in many Asian countries. Success with industrialization depended not just on the country's initial conditions, but also on the implementation of transformative industrial policy institutions. Successful industrial policy in Taiwan and South Korea in the 1950s and 1960s involved the allocation of resources to new firms and sectors as conditional policy rents. The aim was to accelerate technology adoption and learning-by-doing to raise productivity and achieve competitiveness in new sectors. The critical condition for success, as developmental state theorists later pointed out, was that industrial policy agencies could effectively discipline the recipients of policy rents. This capability allowed mistakes to be corrected and ensured that productivity growth was rapid. In China in the 1980s, the industrial policy was different but the enforcement of conditions ensuring productivity growth was again effective, achieving dramatic outcomes.

At the other end of the spectrum were countries in South Asia in the 1960s where the beneficiaries of industrial policy rents were much more difficult to discipline. Powerfully connected business houses, and groups linked to them, captured policy rents and could not be disciplined. Not surprisingly, these countries achieved less significant industrial outcomes. Southeast Asian countries were somewhere in between and achieved moderate success. However, the 1980s saw the beginning of a different type of industrialization in South Asia, led by sectors like automobiles and pharmaceuticals in India and garments and textiles in Bangladesh. Institutions and policies successfully supported capability development in these sectors because policy rents were now delivered in ways that could not be unproductively captured, even in these political settlements.

Developmental state institutions worked in North East Asia and China not because these countries already had market-supporting behavioural norms, nor because they were less corrupt or otherwise better at following market rules. If the appropriate rights, norms, and behaviour already existed, social transformations would not be required (Khan 2004, 2007). Transformational policies are required precisely because pre-existing rights and institutions have to change and new capabilities developed. They inevitably disrupt pre-existing rights and require the creation of many rents as important market failures are targeted. Transformational institutions are successful when they are effective in changing rights and behaviour to achieve more productive societies. For this to happen the enforcement of these institutions has to be aligned with the interests of the powerful.

This chapter is structured as follows. Section 2 outlines Myrdal's contribution to institutional analysis and how modern institutional analysis has built on his analysis. Section 3 sets out an alternative institutional analysis based on political settlements, and the implications for the analysis of the effectiveness of institutions. Section 4 draws on the experiences of Asian countries to explore how developmental policies and institutions worked across political settlements and how appropriately designed transformative institutions can work even in apparently adverse political settlements. Section 5 concludes by discussing incremental versus radical strategies for reforming governance and institutions. While Myrdal advocated radical change, he recognized, with some pessimism, that the incremental approach was the one that most countries would adopt. However, a deeper evaluation of the experiences of the last fifty years suggests that the incremental approach can have less pessimistic prospects than Myrdal thought, particularly if it takes into account the interdependencies between organizational power and institutions.

2. Myrdal and Institutional Analysis

Myrdal posed a question that continues to motivate institutional analysis: why do people not respond to incentives in the same way everywhere (Myrdal 1968: 16–24)? Myrdal rightly criticized economists who assume that responses to economic incentives will be the same everywhere. This was not the case, he argued, because behavioural norms may prevent individuals from responding rationally to economic incentives. He called these patterns of behaviour 'institutions', and in India, Myrdal's main case study, the regressive institutions he identified included the caste system, the taboo on cow slaughter, dysfunctional pre-capitalist structures of land rights, and the management of firms based on caste, family, and ethnic allegiances. What Myrdal describes as institutions include what we would today call formal institutions like property rights or laws against cow slaughter, as well as informal institutions like caste, that are either self-enforced or enforced by informal extra-legal processes (North 1990).

Myrdal's argument was that formal and informal institutions reinforce each other and are therefore difficult to change. Their persistence can prevent the emergence of the behavioural patterns necessary for a modern market economy, including efficiency, diligence, flexibility, enterprise, and even honesty. He concluded that regressive behavioural regularities needed to change, but this was only likely if *compulsion* was used to change these attitudes. But the 'soft' South Asian states were unable or unwilling to impose any social discipline on citizens (Myrdal 1968: 60–3). His response was to propose a big push to change institutions and attitudes because '[i]t is often not more difficult, but easier, to cause a big change rapidly than a small change gradually' (Myrdal 1968: 115). But he did not make clear where he thought such a push would come from.

Figure 13.1 summarizes the links in Myrdal's analysis. The parallels with the later institutional economics of North and his followers are obvious. The argument begins with formal institutions and informal behavioural norms. In Asia these were often regressive, with roots going back to pre-colonial and colonial periods, which Myrdal loosely describes as 'feudal'. These pre-existing institutions include dysfunctional property rights over land, hierarchical caste systems, or other social attitudes that were inimical to the effective operation of a capitalist market economy. Individuals and firms could not respond flexibly to price signals or market opportunities in such a context. To deal with the economic underperformance that followed, states found it necessary to operate a raft of discretionary top-down controls like licensing economic activities, providing subsidies, protecting markets, and so on. The result was the resolution of some problems but the creation of new inefficiencies, since these interventions too could not be properly policed or enforced. We would today describe this as rent creation and corruption. Anticipating subsequent debates over rents, rent-seeking, and governance, Myrdal

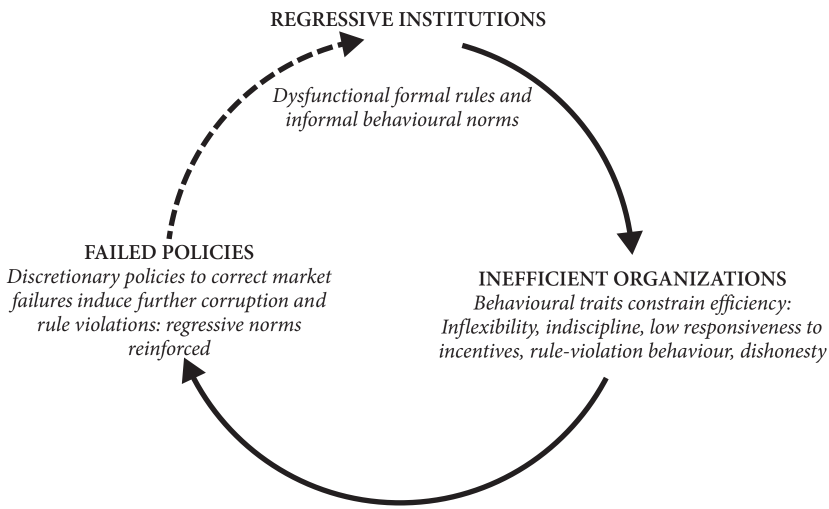

Figure 13.1 Myrdal's institutional analysis.
Source: Author's illustration based on Myrdal (1968: 901–35).

argued that these interventions created 'extraordinarily high profits' (rents) for privileged companies in the private sector (Myrdal 1968: 926). Given the low social discipline, the interventions induced further rule violations and regressive behaviour, completing the loop in Figure 13.1 (Myrdal 1968: 901–35).

Myrdal's analysis anticipated modern institutional analysis whose logical structure is quite similar. It also anticipated the literature on how corrections to market failures can lead to government failures (Bhagwati 1982, 1983; Krueger 1990). Myrdal sometimes argues that regressive institutions persisted because powerful interests benefitted from them, but at other times he argues that they reflected the values and cultures of these societies. In the early part of his work, it appears that regressive institutions are protected by powerful interests. But later Myrdal argues that gradual changes were possible in Europe because reforms were aligned with the values of Western civilization, while in South Asia, regressive social behaviour, stratification, and attitudes were sanctioned by old cultures and popular religion, and so gradual reform was more likely to be overturned (Myrdal 1968: 2114–15).

The distinction between the two positions is important for Myrdal's justification of radical change. If regressive behaviour is embedded in rigid mental models of large numbers of people, there may be no alternative to radical cultural revolutions to break down these ways of thinking. But if the resistance comes from the powerful, attempts at big changes are likely to be violently resisted and incremental reform strategies may in any case work better. For instance, the resistance of different elites may be better dealt with using sequential reforms, or by working in alignment with the interests of some of the powerful to achieve greater productivity and welfare gradually.

The interests of the powerful and the evolution of cultures can clearly interact. Powerful groups can be expected to invest in cultures that support their interests, but these can also become widely shared and provide affirmation and identity to many other groups. A wide range of groups can then use cultural and identity symbols in their own mobilizations. It may therefore appear that culture has an independent existence because it does not mechanically reflect the interests of particular groups. Nevertheless, culture persists because a variety of groups invest in its reproduction and it is therefore important to assess the dominant direction of causality over time. Myrdal's earlier argument that regressive institutions and attitudes are protected by configurations of interests is more in line with my own thinking and with the evidence discussed in section 4. If on the other hand, cultures and norms persist entirely independently because of mental models, we are in a thicker soup. Much later, Douglass North came to a similar impasse when he was trying to explain the persistence of dysfunctional institutions. North resisted explanations based on the distribution of power, and so he had to fall back on mental models to explain institutional stagnation by a process of exclusion (North 1995). The problem is that this can easily descend into a genetic explanation because we then have to explain why some population groups fail to update or reject their dysfunctional mental models in the light of evidence. Fortunately, North abandoned this line of argument before it drove him in that direction.

This is not to say that values, cultures, or religions never have independent effects on the evolution of institutions and organizations. Cultures and norms can influence how different groups across society identify themselves and the narratives they use to mobilize their supporters in conflicts with other groups. As a result, the evolution of organizational power and institutions can be affected by culture and history. Myrdal's warnings about the regressive role of culture and religion can hardly be ignored in the context of the backward slide towards populism and identity politics in large parts of contemporary South Asia and beyond. Even so, the question remains as to whether progress requires substantial social upheavals to destroy these ideological frames or whether incremental strategies can change evolutionary institutional paths. If institutions and policies can be designed to be effective in particular power configurations, and if they support the development of new productive capabilities, the distribution of power can gradually change and allow new groups to invest in the propagation of new cultures and attitudes. We will return to these questions.

The questions Myrdal raised became the subject of a vast outpouring of research in institutional economics and political economy. Liberal rent-seeking analyses drew on the work of Krueger (1974) and Posner (1975) to argue that liberalization was required to reverse discretionary policy interventions of the type that Myrdal had described. This, it was argued, would reduce rent-seeking and corruption and make economies more efficient. The work of North and his associates (North 1981, 1990; North et al. 2007; North et al. 2009; North et al. 2013) and later of Acemoglu and Robinson (2012) identified the formal and informal institutions that supported efficiency (essentially institutions that made market transactions more efficient) and the 'extractive' or redistributive ones that destroyed value. The role of political power found a place in mainstream institutional analysis in the work of Acemoglu and Robinson (2000, 2012).

But the emerging analysis suffered from many of the limitations of Myrdal's original work. The emerging work on rents and rent-seeking ignored the rents created by welfare-enhancing state interventions. If we recognize the possibility of value-enhancing rents, rent-seeking and corruption can be associated with very different development outcomes (Khan 2000a, 2000b, 2006). Similarly, the mainstream work on property rights and formal institutions ignored the fact that capitalist development requires the destruction of many pre-existing rights and institutions. Developing societies are unlikely to have well-enforced formal institutions when their pre-existing rights are going through huge disruptions. Using the institutions and governance structures of advanced countries as the benchmark for developing countries is therefore deeply problematic not only in Myrdal, but also in later authors like Acemoglu and Robinson (Acemoglu et al. 2001; Khan 2012).

Acemoglu and Robinson's (2000, 2012) analysis of power, and their argument that inclusive political institutions empower market-supporting groups, is also based on an inappropriate generalization. Advanced countries are advanced because they have many productive organizations that can benefit from market institutions. Market-restricting monopolies benefit small groups but hurt the majority. Inclusive political institutions in such a context can plausibly empower the productive majority to resist monopolists. The problem of power is more complex in developing countries where the majority may not necessarily support market institutions because they do not yet have the productive capabilities to benefit from them. Instead, large groups can be mobilized with populist or identity politics to demand value-reducing rents or to block the productive restructuring of property rights. In *these* contexts, inclusive political institutions do not necessarily empower market-supporting groups. This is not an argument against inclusive politics, because restricting rent-seeking opportunities in these contexts may sometimes trigger violence and more regressive results. The challenge is to devise incremental institutional changes that can nudge developing societies towards better evolutionary paths.

3. Political Settlements and Institutional Evolution

Given these limitations, it is not surprising that Myrdal and the new institutional economists who followed could not provide convincing explanations for *differences* in performance across developing countries. The high-growth countries in Asia did not have the cultures and values of Western capitalist societies, they did not have well-enforced formal institutions during their transitions, and they did not have very inclusive political institutions. And yet they achieved dramatic capitalist transitions. Moreover, from the 1980s, there were significant growth accelerations in South Asia as well, without the massive disruptions in cultures and attitudes that Myrdal thought would be required.

The 'political settlements' framework addresses this challenge and provides a different analysis of institutions. It builds on three analytical propositions. First, the effectiveness of any institution depends on the responses of the organizations affected by that institution. The horizontal activity of organizations in punishing or isolating rule-violators is at least as important in ensuring adherence as the occasional vertical enforcement by the state. Second, as any institution implies different costs and benefits across organizations, some organizations may support the institution while others resist it. The overall adherence to, or enforcement of, an institution will therefore depend on *the distribution of power across different types of organizations* (the political settlement). Finally, apart from market-supporting institutions (like property rights) a range of other institutions is required to address market failures and maintain political stability. During periods of crisis or rapid transformations, institutions are also involved in organizing changes in rights and creating new capabilities. The operation of 'transformative' institutions can be decisive, particularly in these contexts. The political settlements framework uses these propositions to provide an alternative analysis of institutional performance and policy (Khan 2010, 2018).

The role of organizations in enforcing institutions was highlighted in the work of Greif (2006). He used a game-theoretic approach to describe how institutions can endogenously emerge in repeated prisoner's dilemma games. Institutions for Greif were simply the equilibrium behaviour of organizations. The formal specification of an institution was therefore less important than the actual behaviour of organizations in adhering to particular rules and enforcing them on each other. An implication of this approach, though Greif did not put it like that, is that if equilibrium behaviour diverged from the description of a formal rule, it would appear that the formal rule was being distorted or modified by the behaviour of organizations. His models did not consider the distribution of power across organizations, but in games with multiple equilibria with different distributions of benefits, powerful organizations can be expected to hold out in distributive conflicts until the equilibrium behaviour of other organizations adjusts to support the institution desired by the more powerful (Knight 1992). This takes us to our second proposition. The behavioural regularities that emerge will depend not just on particular punishment strategies, but also on the relative holding power of the organizations involved.

Marxist historians of capitalist transitions in Europe have also identified the importance of distributions of power for understanding the emergence and effectiveness of institutions (Brenner 1976, 1985; Wood 2002). The puzzle they addressed was that the first transition to capitalism was in England rather than in more commercialized or more culturally sophisticated parts of Europe. The Italian city states, the Baltic states, or the Netherlands were more commercialized centres of long-distance trade. The Renaissance was centred in continental Europe. England's advantage could not have been its more advanced culture or its market institutions. Rather, these theorists argued, the first capitalist transformation in England was the outcome of a fortuitous balance of power between peasants, lords, and monarchs that allowed lords to enclose the commons, yet prevented them from reducing the peasantry to serfdom as in Eastern Europe and Russia. The Enclosures gradually privatized common village lands over several centuries, but allowed richer peasants to become capitalist tenant farmers by leasing land from enclosing landlords. This created a landless proletariat and capitalist farmers, but also new inequalities which, far from being aligned with 'Western values', were strongly resisted by the Church (Tawney 1938). Nevertheless, the emergent agrarian capitalism drove innovation and productivity growth. Intense competition between capitalist farmers who had to raise productivity to pay rising rents to landlords led both to the development of technology and the imposition of discipline on workers who adhered to new rules because being landless they had no exit options.

The configuration of power was therefore critical for the English transformation, rather than a hard state or specific cultures and values, though cultural and other factors may have played some role. Similar institutions did not emerge in much of Europe till military competition with Britain persuaded Bismarck, Napoleon, and other state leaders to organize political coalitions to push through institutional transformations from above that achieved capitalist transitions. Similar state-led transitions began in Asia with the Meiji revolution in Japan in the nineteenth century, which foreshadowed transitions in Taiwan and South Korea in the twentieth. In each case, the transition was driven by different types of state and non-state organizations but, in all cases, a specific distribution of organizational power enabled outcomes that led to the emergence of new institutions and more dynamic societies. These institutional changes were mostly gradual rather than revolutionary breaks with pre-existing cultures and norms, though the latter changed over time as production systems and power configurations changed.

In every case, there was resistance from losers, but the losers were typically not the small groups of privileged monopolists, as in Acemoglu and Robinson's analysis. The resistance to the Enclosures in Britain came from peasants. Far from inclusive institutions assisting the majority, the dispossessed peasants could not block these changes because parliament was *not* inclusive enough. Representation was restricted to property owners. Nor did parliament play a role in ensuring that peasants were rapidly or fairly compensated. They were not compensated at all. Parliament therefore played no direct role in the institutional transformation. The transition was successful because landlords could expropriate common lands without much peasant resistance, but they could not expropriate the peasant's own land because peasants had sufficient collective power at the village level. This fine balance of power ensured a capitalist transformation of agriculture that eventually led to an improvement in welfare across classes. The configuration of organizational power and political institutions mattered, but in more complex ways than Acemoglu and Robinson suggest.

Finally, a large heterodox literature has discussed the role of institutions in addressing market failures and transforming rights and capabilities during social transformations. The diversity of outcomes can be examined through the lens of rents and the management of rents (Stiglitz 1996; Khan 2000a, 2000b, 2004). Rents can be defined in a number of ways, but they usually refer to incremental incomes associated with specific institutions. Some institutional changes, like the creation of artificial monopolies, create rents that are socially damaging. But welfare-enhancing interventions that create or reallocate property rights or address market failures also create incremental incomes somewhere. What types of rents are created and how they are allocated and managed can serve as a useful lens for assessing the rent-creating institutions. Dynamic societies have institutions that allow growth-enhancing transformations of rights and the creation and management of rents that drive learning, innovation, and political stability. Less dynamic societies mismanage rents, allowing some groups to capture assets and rents without delivering results, or they create rents that are directly unproductive, like monopoly rents or conflict-inducing redistributive rents.

Since all institutional changes create new incomes, they inevitably create rents. Not surprisingly, the emergence of institutions is usually driven by rent-seeking and they create incentives for further rent-seeking. Outcomes depend on the institutions regulating rent-seeking and the distribution of power across relevant organizations. Rent-seeking can result in the creation of socially useful institutions, distortions in the implementation of useful institutions, or the creation of damaging institutions (Khan 2000b). Rent-seeking is just as ubiquitous in advanced countries but the adherence to a rule of law means that rent-seeking processes here are generally rule-following and part of 'normal' politics. However, legality does not ensure good social outcomes, and the converse is also true. Both legal rent-seeking (like lobbying) and illegal variants (like bribing and patron–client politics) can be associated with socially damaging, less damaging, or beneficial institutional outcomes.

In developing countries, powerful organizations typically do not support a rule of law. This is because even organizations that are not predatory are often not productive enough to survive against more productive competitors elsewhere without informal rents. And because they are few in number, they can also transact with each other using informal contract enforcement, without a rule of law. Adherence to a rule of law by the powerful is therefore unlikely in these contexts and rent-seeking, too, is likely to be illegal or extra-legal, often taking the form of corruption. Politics is therefore likely to have a rule-violating character. Low tax revenues also mean that promises to spend the budget in rule-following ways are unlikely to attract powerful organizations to support particular parties. These characteristics of developing-country rent-seeking can explain why patronage and political corruption are typically part of their 'normal' politics (Khan 2005).

Given the nature of rent-seeking in these countries, it is not surprising that developing countries, including successful ones, typically suffer from high levels of corruption. South Korea in the 1960s or China in the 1980s had significant levels of corruption and yet achieved rapid development. Myrdal's analysis of corruption and later mainstream analysis does not address this challenge. The variations in the outcomes of corruption become explicable once we recognize that the real differences between countries are in the types of rents created by organizations and how they are managed by other organizations. Where the conditions of allocating and withdrawing rents support productivity growth, desirable results can be achieved despite rent-seeking. Corruption declines over time in these countries as productive capabilities develop and the growth in the number of productive organizations creates growing organizational support for formalization and rule-following behaviour (Khan 2005, 2006).

The management of industrial and technology policies allows us to examine the significance of the distribution of power for the management of rents. Developing-country firms typically have low initial capabilities. Myrdal recognized the critical importance of learning-by-doing, a process later analysed by Amsden (1989) and others. Developing countries do not have to invent new technologies; they can just learn how to use existing ones (Myrdal 1968: 691–6). However, market failures may prevent investments in learning-by-doing, a problem Myrdal did not adequately recognize. Amsden (1989) argued that learning needed to be supported by targeting conditional rents to emerging business, but the latter also had to be disciplined, and rents sometimes withdrawn to ensure that these were not wasted.

Evans (1995) later contributed the concept of 'embedded autonomy' to explain why intervention by strong East Asian states achieved productivity growth rather than rent extraction. These states had the power to extract resources from business, but they used their power to raise productivity instead. Evans argued that this happened because government agencies were embedded in dense business–government networks that allowed the knowledge and interests of the business sector to be incorporated into policy.

While developmental state theorists provided a deeper analysis of institutions and rents and went beyond the focus on market institutions, their analysis was still largely a purely institutional one. They ignored the configurations of power that enabled some institutions to work in specific contexts but not others. The rent-granting and rent-withdrawal institutions that Amsden and others identified in East Asia existed in similar forms in South Asia where they achieved far less impressive results. South Asian states had sufficient autonomy to destroy or constrain many good businesses, but they did not discipline the bad ones. Similarly, dense networks between business and government in South Asia and sometimes in Southeast Asia resulted in crony capitalism rather than efficiency-enhancing information sharing. The differences between these cases cannot be understood by looking at institutional structure alone, we need to understand how specific configurations of organizational power made similar institutions operate differently.

Figure 13.2 summarizes our distinction between a 'pure institutional analysis', which focuses on the incentives created by formal and informal institutions that *may* result in particular outcomes, and the political settlements extension, which looks in addition at how the specific distribution of power across organizations affects the *actual* adherence to and enforcement of these institutions. Note that the introduction of particular institutions and policies on the left-hand side is not entirely predetermined by existing power structures. Otherwise, societies would be completely trapped by the interests of those who are already powerful. There is always some policy space for the introduction of new institutions and policies

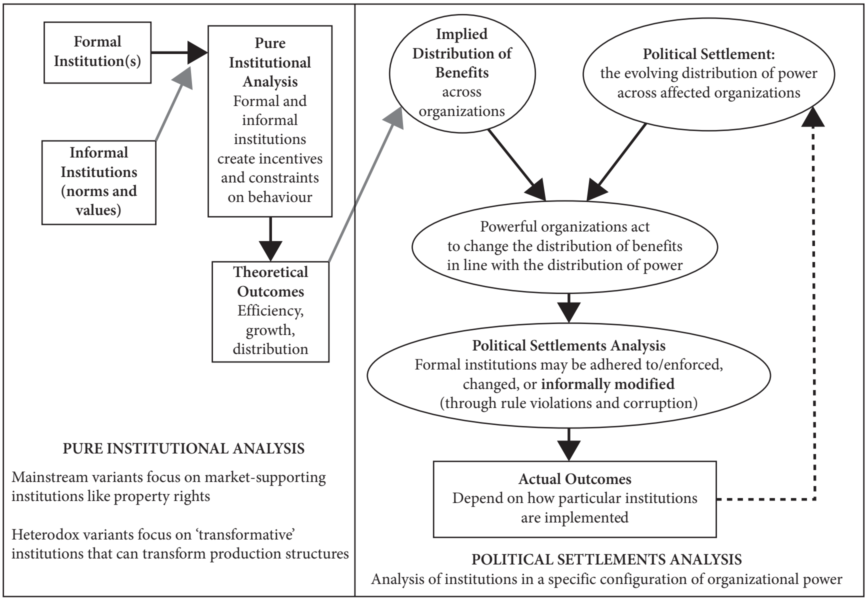

Figure 13.2 Political settlements and institutional outcomes.
Source: Author's illustration based on Khan (2010, 2018).

that innovative political leaderships or organizations can exploit, but their implementation and final effects do depend on the reaction of a broader range of organizations.

The distribution of power across organizations is the 'political settlement' at the top right-hand corner of Figure 13.2. This describes the holding power of organizations affected by a particular institution. The country and sector-specific configurations of organizational power can only be inferred from a reading of history, which is why institutional analysis cannot be generalized from particular cases or derived from first principles. Holding power is not just based on the economic power of organizations but also on their organizational power to hold out in conflicts while inflicting costs on others. Ignoring the power and interests of organizations is one reason why pure institutional analysis remains deficient, both the mainstream variants focusing on market institutions and heterodox variants looking at transformative institutions. Every institution or policy has distributive implications, and organizations can be expected to support or resist their implementation. If institutions create rents or seek to manage rents in ways that are against the interests of powerful organizations, the latter will resist by trying to change the institution or to informally modify its implementation using corruption or informal violations. Fully effective adherence is a boundary case. Note that informal modifications here have little to do with norms and everything to do with the alignment or otherwise of the distribution of rents and the distribution of power. Actual economic outcomes depend on how particular institutions or policies are implemented, not just their theoretical effects. Figure 13.2 also shows that the political settlement is itself affected by economic outcomes which change the distribution of power over time. It is this evolutionary dynamic that a historical analysis of institutions must attempt to capture.

Depending on how the outcomes of particular policies and institutions affect the development of organizations, the relative power of organizations will evolve in particular ways. Radical change from this perspective is only necessary if the existing political settlement allows no incremental improvements in outcomes. The radical change in question would involve political mobilizations and the creation of new organizations that sought to *directly* change the political settlement at the top right-hand corner of Figure 13.2. The danger is that mobilizations on this scale can just as well trigger counter-mobilizations of even more regressive coalitions, while incrementalism may actually result in more sustainable progressive changes in the political settlement over time.

4. Comparative Institutional Experiences

The analytical links described in Figure 13.2 can help to make sense of comparisons between North East Asian and South Asian experiences in the 1960s, the period that Myrdal looked at. They can also help us to understand institutional evolution since that time. South Korea began its industrial take-off shortly after Park Chung Hee took power in a military coup in 1961. By then South Korea had already carried out substantial land reforms as the Japanese occupation had forcefully dispossessed the most powerful elements of the Korean *yangban* landed elite and converted much of their land to Japanese ownership. With the departure of the Japanese, land reform based on the redistribution of Japanese land and the compulsory purchase of land from the remaining landlords was relatively easy to achieve. These reforms led to a significant equalization of landholdings and a dramatic reduction in the number of tenants as they became smallholders. However, it did not create a class of yeoman tenants on the English pattern who could drive an agrarian capitalist revolution from below. The global conditions were not right for smallholding agriculture to make much of an impact on South Korea's economic progress. At best, the land reform created political stability in the countryside in the face of the communist threat from the North, expanded the domestic market somewhat, and perhaps created a greater demand for education in the countryside (Kohli 1994; Putzel 2000).

The real impetus to South Korean modernization came with its industrial push in the 1960s. A critical feature of the new institutional structure was the provision of significant rents to the *chaebol* (the large family-owned conglomerates of South Korea), to enable them to engage in learning-by-doing to improve their organizational and technical capabilities (Amsden 1989; Khan 2000b). The institutions supporting their learning also compelled the *chaebol* to rapidly acquire international competitiveness by withdrawing support if they failed to perform. The credibility of the withdrawal threat created compulsions for rapid productivity growth and ensured that infants did not require permanent support. Myrdal's fear that unproductive rent capture would compound the problems that any interventions tried to solve did not materialize in South Korea.

Why did South Korea not fall into this trap? Pakistan provides a good comparison with South Korea because it attempted a similar mix of import substitution and export promotion, and provided rents to large holding companies using similar instruments (Khan 1999). Indeed, in the early years, South Korean planners came to Pakistan to learn about planning strategies. While there were many differences between the two countries, the decisive difference was that large Pakistani companies were connected to powerful and dense networks within the bureaucracy, army, and political parties, and could use their help to successfully retain rents even when their failure to become competitive had become obvious.

The organization of patronage networks in Pakistan was fragmented, but each network was powerful enough to resist disciplining by others or by state agencies. In the late 1960s, the media openly reported how 'twenty-two families' had captured public resources, but the military regime was unable to impose discipline on its inefficient clients. There was much corruption in this process, as Myrdal recognized, but it was more than just a problem of corruption. The value-reducing rent capture by powerful networks hurt the legitimacy of the ostensibly powerful military government. It tried unsuccessfully to rein in its clients, including revealing their names and the money they owed, but it failed. The regime was eventually brought down in 1971 as a result of popular mobilizations against cronyistic elites. The failure was deeper than knowledge, values, or interests. The top leadership had strong incentives to limit rent capture by uncompetitive business groups but they failed to overcome their resistance. The nature of the failure suggests that a different policy design, perhaps supporting smaller, less-connected capitalists, or rewarding investors after they had achieved some results rather than giving all the rents upfront, may have worked better in this political settlement. Indeed, we find that other strategies of supporting learning worked much better in a number of sectors in South Asia in the 1980s.

We know as a result of later revelations by the *chaebol* that the allocation of industrial policy rents in South Korea in the 1960s involved much corruption. But, here, corruption did not featherbed inefficiency. The *chaebol* receiving support knew they had an opportunity to become competitive, but they also knew that the option of capturing the rents while remaining uncompetitive was not feasible. This was because the state agencies monitoring them were more powerful than the networks that individual businesses could mobilize. The agencies figured out that their formal *and* informal payoffs would be higher if they reallocated rents to *chaebol* that could grow and generate additional profits rather than inefficient ones that could not. Corruption still happened, but here it was of a profit-sharing type. The *chaebol* needed the support of the state, and they were willing to treat the political leadership as informal business partners who could claim a share of profits as 'dividends'. The logic was simple, and both sides soon worked out that profit-sharing corruption was not only *not* contrary to productivity growth, given the distribution of power, it created incentives and compulsions to achieve productivity growth. The rent allocation rules could not be distorted because critical agencies had the interest and the power to prevent it (Khan 1998, 2000b).

Where did this capacity come from? It is hard to argue that contemporary South Korea had a culture with attitudes of rationality and discipline that were significantly superior to South Asia. True, it had a more developed industrial history as a result of Japanese colonialism, but this cannot explain why inefficient firms were not allowed to capture rents. The capacity to withdraw rents and discipline the *chaebol* is more plausibly explained by a specific political settlement. The historical roots of this can be traced back at least to the impact of Japanese colonialism. The latter was brutal, but it did not create a fragmented and competitive set of political organizations in its colonies, as the divide-and-rule strategies of British colonialism created in South Asia and elsewhere. The post-war South Korean political settlement was marked by an absence of powerful *competitive* networks within the state and bureaucracy, so individual *chaebol* could not collude and share rents with parts of the network to prevent themselves being disciplined by other parts.

When the South Korean state began its industrialization drive, its leaders did not have pre-conceived ideas about how to make rent allocation achieve dynamic results. Rather, trial and error revealed that making support to a *chaebol* conditional on the achievement of export targets resulted in rapid productivity growth because the rule could be enforced. The *chaebol* put in lots of effort to raise productivity, knowing that the alternative would be disastrous for them. Once the enforceability of these rules became known, the system evolved in a particular direction, with more ambitious learning strategies emerging. In contexts where state support could be combined with rules that compelled companies to achieve productivity growth, similar types of corrupt but 'efficient' profit sharing emerged in a number of Asian countries, including China in the 1980s.

Trial and error revealed a very different political settlement to South Asian state leaders. Leaders in Pakistan and India were soon aware that industrial policy rents were being unproductively captured and though this was not in their interest they failed to discipline their clients. While individual bureaucrats and politicians benefitted, the higher-level leaderships lost out in terms of overall revenue and legitimacy. Individual businesses constructed alliances with powerful political and bureaucratic networks that undermined any possibility of disciplining them. The failure to govern rents was ultimately not due to flawed mental models but rather a configuration of power that made it impossible to impose discipline on these firms.

In India, Myrdal argued that productivity growth was not even an explicit goal of import protection, the latter was justified simply by the need to conserve foreign exchange (Myrdal 1968: 1158). This is not true. Using protection as a rent allocation instrument to develop domestic productive capabilities was a demand of the nationalist movement, and it was supported by emerging Indian capital in the Bombay Plan of 1944. Moreover, the failings of the industrial licensing system were of great concern to the Indian state (Chakravarty 1987). However, when state leaders discovered that efficiency could not be achieved, they would occasionally justify their policies by saying this was not even their intention.

We know from the report of the Industrial Licensing Policy Inquiry Committee (Dutt 1969) that Indian policymakers were painfully aware that businesses they supported were not meeting their licence conditions and instead using their licences to behave like monopolies. The Dutt Committee recommended sanctions on business houses that failed to comply with licence conditions, but this was not implemented. As in Pakistan, the problem was clearly neither ignorance nor the interests of state leaders. Rather, the peak agencies that wanted to achieve productivity growth were weak relative to the powerful networks below them who saw greater benefit in capturing rents without delivering results and using the rents to sustain their power through patronage networks. The distribution of power was the real source of this prisoner's dilemma outcome, while the ability of political leaderships in developmental states to discipline free riders allowed the pie to increase for everybody. Institutions and institutional outcomes reflected the political settlement rather than values or norms.

We turn now to Myrdal's analysis of the soft state. It is true that planning agencies in South Asia could not discipline businesses protected by political entrepreneurs from the intermediate and upper classes and their clientelist networks. But other state agencies *were* able to discipline subaltern classes or regional separatist movements. In these conflicts, states in India and Pakistan were ready to use overwhelming force to 'discipline' segments of their societies. The enforcement problem was therefore limited to specific sectors and institutions rather than being a general malaise of social indiscipline. The *specific instruments* that were used, particularly for promoting industrial development, had governance and disciplining requirements for *specific organizations* that could not be adequately enforced. The implication is that other institutions and instruments allocating rents to a different set of organizations may have achieved better development results.

This insight can help to explain the significant growth accelerations in a few sectors in India and Bangladesh in the 1980s with relatively minor institutional and policy innovations. The previous industrial policy had achieved *output* growth in many sectors, but *productivity* growth was low because of poor disciplining. As a result, competitiveness was typically not achieved in most sectors (Acharya et al. 2003: table 2.2; Virmani 2004: table 1; Bosworth et al. 2007: table 3). The growing economic openness from the 1980s helped imports of capital and machinery, which supported productivity growth. But the achievement of competitiveness also required policies that assisted learning and capability development. What is interesting is that relatively minor institutional and policy innovations created the compulsions for productivity growth that were previously missing.

The new policy and institutional innovations in a few sectors were successful because rents were delivered to organizations that did not have the power to protect them unconditionally. Conditions could be credibly enforced that would hurt the firms if they failed to deliver results. An important feature in several of these take-offs was that investors were induced to *first* invest their own resources in learning, with policy promising sufficient *ex post* rents to give a high return on their risky investments if they succeeded.

I have discussed these examples at greater length elsewhere; they included automobiles and pharmaceuticals in India and garments and textiles in Bangladesh, sectors that drove growth accelerations in these countries from the 1980s onwards (Khan 2011, 2013a, 2013c). The cases are different, but we can summarize the Bangladeshi garments and Indian automobiles cases to illustrate their common features. In these two cases *ex post* rewards were created for a foreign partner to transfer capabilities to domestic firms. In a third sector, Indian pharmaceuticals, the story was slightly different. Here *ex post* rents were created for domestic firms if they succeeded in developing manufacturing capabilities by backward engineering based on the application of the Indian Patent Act of 1970. But all these sectors were similar in rewarding successful capability development *ex post* as a way of encouraging prior private investments and being successful in the implementation of these rules.

In the Bangladesh garments sector, the critical instrument was an agreement in 1979 between a Bangladeshi company, Desh, and a South Korean company, Daewoo, backed by the Bangladeshi state. The context was the Multi-Fibre Arrangement of 1974, which created potential *ex post* rents for least-developed countries like Bangladesh if they could achieve sufficient quality and competitiveness to sell garments in the quota-protected US market. The protection created quota rents in the US market, and the agreement was to pass on the potential quota rents to Daewoo as its reward for transferring export capability to Desh (Khan 2013b). The rule essentially transferred a percentage of future sales revenue to Daewoo, and this was sufficiently rewarding for it to invest in capability transfer. What made the rule easy to enforce was that unless Desh acquired the capability to export, no one would make any money. No *ex ante* rents were allocated to powerful businesses in Bangladesh, so there was no possibility of capturing these rents. The rule for transferring quota rents to Daewoo was also credible because the Bangladeshi state could prevent a relatively small firm from violating a contract that the President saw as vital for the country.

This combination of credible *ex post* rents for Daewoo and compulsions for investors to recover their investments resulted in dramatic capability development. Desh became a competitive firm within months of sending an army of supervisors to South Korea to learn factory and supply chain organization. As the organizational design that it adapted was appropriate to Bangladeshi conditions and could be easily imitated, thousands of Bangladeshi entrepreneurs entered the garments industry. The explosive growth of the sector created millions of jobs and within two decades Bangladesh had become the second biggest garment producer after China, though still far below China in absolute terms.

In the Indian automobile industry, the government signed a joint venture agreement in 1982 between Suzuki, a Japanese company, and Maruti, a public sector Indian company, allowing Suzuki to sell in the highly protected Indian market if it could produce an Indian car with sixty per cent domestic content within five years. Given that Indian tier one and two producers already had basic technical capabilities, the incentive of capturing significant tariff rents *ex post* was sufficient for Suzuki to invest in developing the capabilities of its Indian suppliers. Here, too, the mechanisms of rent allocation were credible to the parties, as was the enforceability of the conditions.

Rents could not be captured by Indian components producers because no *ex ante* rents were transferred to them. A failure to achieve international standards with Suzuki's help would simply be a lost opportunity for future profits. Suzuki knew that the strong opposition to its operations from domestic automobile and machine tools producers meant that a failure to achieve the domestic content conditions would result in exclusion from the Indian market. There was no question of the capacity of the Indian state to enforce this condition. As Suzuki was investing first, it had strong compulsions to succeed as that was the only way to capture the *ex post* tariff rents. Once again capability development was rapid and successful, and similar deals with other foreign companies followed. By the 1990s, India's auto components industry had become globally competitive. By the turn of the century, the sequential upgrading of auto components producers enabled India to produce its own branded cars. It became one of the few global car producers that could produce globally competitive national brands.

In both these cases incremental institutional and policy changes turned out to be enforceable from the perspective of specific developmental goals, given the distribution of power across the organizations involved, including relevant governance agencies. This is potentially a promising escape from the bind of weak enforcement, because it exploits the observation that in most states, enforcement failure does not extend to all dimensions. Economic development would be more rapid, and strategies of inclusion more effective, if these opportunities were more thoroughly exploited. The importance of the appropriate design of policies and institutions across different political settlements is insufficiently understood, which is why Bangladesh and India have not been able to replicate their own successes in many other sectors.

Looking at South Korean or Taiwanese industrial policy as paradigmatic has been very damaging for follower countries. These North East Asian states inherited political settlements from Japanese colonial times that were characterized by the absence of powerful factional political organizations. These states had the capacity to enforce conditions on firms receiving rents because the latter could not construct coalitions with powerful factions to protect their rents for a price. As politicians and bureaucrats discovered their enforcement capacity, sequential improvements in policy design followed. These countries did not have the cultural norms of the West, but the gradual productive transformation of their societies through the development of capabilities and competitiveness created a very similar impetus for investments in education, health, and culture. This took them in the direction of modern societies, including a transition from learning to innovation societies. With the transition to innovation increasing in pace over the last two decades, the dominance of institutions supporting catching up has been gradually superseded by institutions supporting innovation. While the achievements of these 'developmental states' have been truly impressive, the institutions and policies that they used to achieve development are not replicable in other states, even in Asia, where the political settlements are substantially different.

South Asia inherited a very different political settlement. Both democratic and authoritarian governments in India, Pakistan, and Bangladesh discovered their enforcement capabilities were limited when they faced powerful political and bureaucratic factions organized by the 'intermediate classes'. Myrdal described a moment in the history of these countries when they were using policy instruments that were seriously distorted in their implementation. Subsequent developments in the 1980s and beyond show that substantial growth could be achieved with policies and institutions allocating rents in other ways, even though these have not been developed to their full extent. Nevertheless, the long-run pace of development in South Asia is likely to be slower and more uneven than in North East Asia. South Asian states do not have the political and institutional capacity to support development across a broad range of sectors and regions all at once, as these strategies typically require disciplining a broad range of policy rents. Moreover, the poor results of bureaucratic management and the involvement of politicians and bureaucrats in value-reducing variants of corruption have had negative effects on morale. The very best graduates no longer find a career in the civil service sufficiently rewarding in most parts of South Asia, and this has had negative cumulative effects on bureaucratic capacity.

Southeast Asia has been somewhere in between in terms of the complexity of their internal power structures, and therefore in the constraints on enforcement set by their political settlements. Over the longer term their success has been somewhere in between South and North East Asia. From the perspective of the political settlements framework, it is not surprising that we find a great diversity of economic strategies and institutions that have worked and failed across these countries (Khan 2000b, 2007). Southeast Asian countries, too, have come a long way in the half-century since Myrdal wrote his *Asian Drama*, and some now face new challenges of progressing from learning to innovation societies while dealing with emerging challenges of populist politics.

5. Incremental versus Radical Reform and Prospects for the Future

On one critical question, the jury is still out. Myrdal posited that incremental changes were not only more painful than radical or revolutionary changes in the long run; incremental strategies were also more likely to fail. The case against incrementalism that Myrdal posited still affects many variants of modern institutional analysis. Acemoglu and Robinson are arguably in the same tradition in ruling out the sustainability of growth without a big shift towards inclusive political and economic institutions. For Myrdal, incrementalism was an excuse for unproductive elites to keep tolerating indiscipline and regressive practices (1968: 1909–10). However, neither Myrdal nor Acemoglu and Robinson have a convincing explanation of where the big changes will come from. Even if leaderships emerged in these countries with very different beliefs and a willingness to unleash discipline on society, or even if the critical junctures that Acemoglu and Robinson identify as the prelude for big changes came around (Acemoglu and Robinson 2012: 110–23), there is no guarantee that the radical reform strategies that may follow would be sustained over time.

If we are right in arguing that the distribution of power in society is relevant for institutional outcomes, attempts by political movements to enforce radical changes on the powerful could unleash substantial counter-mobilizations, violence, and very high 'transition costs' (Khan 1995, 2012). Nor is it clear that incremental strategies are more likely to fail if they can be appropriately constructed. What is clear is that many of the formal institutional and policy strategies that Myrdal looked at did indeed fail in India because their requirements of enforcement and adherence were unrealistic. But a leadership that was developmental could have followed an incremental strategy that took into account issues of enforcement to identify institutions and policies that were more likely to be effective for achieving development in that social context.

The elephant in the room for making these comparisons is China, a country that Myrdal did not include in his original study and one that Acemoglu and Robinson write off as unlikely to succeed given its 'non-inclusive' institutions (Acemoglu and Robinson 2012: 428–46). In fact, China is not only the most dramatic developmental transformation in human history, it also went through massive upheavals and revolutionary changes in the organization of its society. These radical changes could have contributed to its success in two quite different ways: the upheavals could have destroyed pre-existing regressive cultures and attitudes in Myrdal's sense, or they could have helped to create a disciplined organization, the Communist Party, with a new power structure that was effectively a new political settlement. The distinction is important. The cultures and attitudes that the communist revolution tried to root out were precisely the individualistic profit-seeking attitudes and property rights that were revived after 1979 during the growth transformation. One could argue that the upheaval helped to reboot pre-existing norms, to make them more appropriate for modern capitalism, but surely a less costly route could have been tried. Tens of millions of lives were lost or disrupted in the Great Leap Forward and the Cultural Revolution and yet many aspects of pre-revolutionary culture survived.

A more compelling case for the potentially positive effects of revolutionary disruption is that it may have enabled the construction of a relatively disciplined and inclusive political organization, the Communist Party, with the political power to allocate resources and discipline their use on a scale not possible in other developing countries. The Communist Party gradually came to include within it almost all of the politically active Chinese population, and it developed formal mechanisms for reaching compromises and enforcing agreements on collective rent allocation decisions. Decades of conflict and organizational activity were necessary to create this political structure but once it had emerged, the enforcement of collective decisions about resource and rent allocation was much more effective relative to other developing countries. The political settlement that the Chinese Communist Party represents may not be a permanently sustainable one, nor may it be the most appropriate one for enforcing the new types of rights and contracts that will be required as China moves from a learning to an innovation society. But it was very effective in organizing the post-1979 economic miracle based on adopting and adapting existing technologies and attracting significant foreign investments.

While the end results of the revolution were clearly positive, regardless of how we explain it, the policy implications are not clear. If the construction of a disciplined and inclusive political organization is the element that explains China's subsequent institutional success, this is by no means assured as an outcome of an upheaval. Upheavals can destroy pre-existing institutions and organizations without necessarily leading to the emergence of a disciplined and inclusive organization. Massive upheavals are more likely to create unmitigated chaos for long periods. The answer to Myrdal's social discipline and soft state problem may be to look much more seriously for incremental answers that take us in the direction of more organized and disciplined societies. I find very promising the examples of successful sectoral development in Myrdal's 'soft states' in the 1980s and beyond. These provide rich but all-too-rare examples of strategies that may work to accelerate the social transformation of countries in progressive and inclusive directions. If incremental strategies can be sustained across sectors and regions (and that is admittedly a big if), these strategies could gradually result in the multiplication of successful sectors and organizations, which may eventually want a better formal enforcement of social rules in general.

The growth and empowerment of powerful productive organizations that will eventually *demand* the enforcement of rules in their own interest is the only sure way of eventually creating an effective demand for a transition to a rule-following society. As against this, regressive interests and organizations in these societies can also be expected to mount their own rent-seeking and influencing activities. We can expect them to try and distort institutions in ways that can be described as social indiscipline, corruption, regressive social norms, and impunity. The pace of, and prospects for, development are likely to depend on the contest between these contending forces.

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